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United States: Federal Reserve System Rules Concerning International Banking Facilities: Introductory Note

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UNITED STATES: FEDERAL RESERVE SYSTEM RULES CONCERNING INTERNATIONAL BANKING FACILITIES*

Introductory Note

A complement to the post World War II extension of convertibility to Western European nations' currencies was the tremendous growth in the international capital market in the 1960s and 1970s. These markets are ones where banks can fund their lending and make loans, and nonbanks borrow and/or float notes or bond issues, free of domestic money and bond market regulation and often at better -- or at least different -- rates than in the domestic capital markets. For multinational banks and merchant bankers, participation in these markets can be both profitable and a reliable cushion against periods of domestic stringency. At one point First National City Bank was reporting approximately 60% of its earnings from international business. Moreover the markets themselves were and are celebrated as the mechanism by which the OPEC surpluses were "recycled," thus "saving" the international monetary system from toppling into the petrodollar sands. (That the largely unregulated "recycling itself may have created another form of instability -- very heavy Third World and Eastern European debt to the private system -- is only now being recognized).

The position in these markets of multinational banks headquartered in the United States was, however, always anomalous. The great bulk of the trade in the international capital markets is denominated in dollars, the national currency of banks headquartered in the United States, but

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[The Federal Reserve Rules concerning International Banking Facilities begin at I.L.M. page 878. As of July 30, 1982, nine states had passed specific legislation concerning international banking facilities. They are: California, Connecticut, Florida, Georgia, Illinois, Maryland, New York, North Carolina and Washington. In general, this state legislation exempts international banking facilities from state and local income or franchise taxes.

[The International Banking Act of 1978, referred to in the Introductory Note, appears at 18 I.L.M. 167 (1979).]

because of the particular form of regulation of banking utilized in the United States, these banks could only participate in the so-called Eurocurrency markets through offshore branches or subsidiaries at which the offshore loans and deposits could be booked. Thus the 1960s saw the opening of London branches by over 100 United States banks and the 1970s the "shell" branches in the Caribbean. The form of regulation of U.S. banking that forced U.S. banks to open offshore offices to participate in the Eurocurrency markets is the system of attempting to control the domestic money supply through reserve requirements, requirements that commercial banks hold a particular portion of their deposits in non-interest bearing accounts with the Federal Reserve banks. The original legislation setting up the system of reserve requirements is part of the Federal Reserve Act; the regulation under it is Regulation D of the Board of Governors of the Federal Reserve System. 12 C.F.R. Part 204.

To the extent that any particular deposit (or borrowing by a bank as Regulation D defines numerous liabilities of banks as being included in "reservable" deposits) is subject to being reserved against, that deposit costs the bank taking it more than a deposit to which the reserve requirements are not applicable. If deposits cost U.S. banks more, they cannot compete on an equal basis with other multinational banks for international deposits. Equally, U.S. banking regulation, for reasons of domestic policy, has limited the amount of interest that banks may pay on deposits and other liabilities included in "deposits." (The regulation setting out the interest rate ceilings for commercial and savings banks is Regulation Q. 12 C.F.R. Part 217). Once again, if U.S. banks cannot bid more than the interest ceiling for deposits, they cannot compete in the international money markets for funds to lend. However, very early on in the history of these forms of banking regulation, the Federal Reserve Board (the Fed), fully aware of the need of the few

United States banks that had foreign branches to compete abroad with the differently regulated banks of the countries in which the branches were located, had interpreted the reserve and interest rate legislation not to apply to deposits "payable only abroad." Conceivably, this term could have covered deposits booked at offices within the United States but which were, by the deposit contract, payable at a location (the office of a foreign correspondent bank) abroad, but in practice the term came to mean deposits which were booked on foreign branch or subsidiary books and appeared as liabilities of those offices. (National banks, by a quirk of the law, are required to keep separate books of account for foreign branches.) Hence, when in the 1960s the opportunitites for profit by participation in the international money and capital markets became evident to many more U.S. banks than just those that had traditionally had a foreign branch network, the rush to open on site London offices through which the business could be done -- free of reserve requirements and interest rate limitations. (The Carribbean "shell" branches offered tax advantages in addition.)

Obviously, however, if numerous U.S. banks raise funds abroad through their London offices free of reserve requirements and then either send those funds back to their head offices in the United States for domestic lending or lend those funds to customers for use in the United States, the supply of "money" in the domestic economy is increased and, depending on the relative cost of those funds, the banks with the London offices have a competitive advantage over banks without the foreign office that must sterilize some portion of the deposits they get in the reserve accounts. (U.S. branches of foreign banks had the same competitive advantage until the International Banking Act of 1978, Pub. L. 95-369, Sept. 17, 1978, 92 Stat. 607, applied reserve requirements to deposits booked in the U.S. by foreign banks). This problem of use in the United States economy of "unreservable" funds is one that is referred to by those concerned with monetary policy as "leakage." To counter this erosion of its monetary tool of reserve requirements, the Fed developed an elaborate set of amendments to Regulation D that made funds raised abroad reservable against if the banks brought them home or lent them to customers for use in the United States. For a complete history of the tinkering with Regulation D and Congress' finger in the pie with the Monetary Control Act of 1980, see Lichtenstein, U.S. Banks and the Eurocurrency Markets: The Regulatory Structure, 99 Banking L.J. 484-511 (1982). Within the limitations of the Regulation D dike against "leakage," U.S. banks continued to participate in the Eurocurrency business through their foreign offices.

However, whatever the tax, interest rate and reserveless advantages of deposits booked at offshore offices, the offshore deposit gathering capacity has one large disadvantage: for the purposes of so-called "country risk," those deposits are situated abroad, within someone else's territorial jurisdiction. While the United States has had the temerity to assert jurisdiction (for such purposes as the blocking orders against the Iranian government's assets in the hostage crisis) over deposits in U.S. banks' and bank subsidiaries' offshore offices, no one has ever suggested that such offshore deposits in U.S. owned banks are immune from the jurisdiction of the host country. In times when the dollar is strong, or for other reasons it seems desirable to hold liquid dollar assets, a dollar short-term or even demand account on the books of a bank in London or Hong-Kong or Bonn is very nice; but even so, London or Hong Kong or Bonn might choose suddenly to impose exchange controls on the movement of foreign currencies within their borders. (Remember, all any party to the IMF Agreement has promised in that treaty to do is to buy and sell <u>its</u> own currency; no one (other than the

U.S.) promises under Art. IV of IMF Agreement to allow free trading in U.S. dollars within its territory.)

Clearly, therefore, U.S. multinational banks could compete in the Eurocurrency markets best if they could offer to take dollar deposits booked and payable within the United States. (The banks had already long since tried the gimmick of head office guarantee of foreign branch deposits; Fed had ruled that such a guarantee made the deposits reservable. See Lichtenstein, op. cit., at 488.) Thus, on July 14, 1978, having already persuaded the New York legislature to pass a bill exempting the income from Eurocurrency business brought "home" to New York from New York State and City taxes if the Fed would exempt such "free-zone banking" from reserve requirements, the twelve New York banks that make up the membership of the New York Clearing House submitted to the Fed a position paper entitled "International Banking Facilities in the United States: An Analysis of the Economic Policy Issues" urging that Fed amend Regulations D and Q to permit U.S. banks to book foreign owned deposits in the U.S. and use (loan out) those deposits free of reserve requirements and interest rate limitations so long as the funds did not leak into the U.S. domestic economy. A student note, International Banking Facilities: Defining A Greater U.S. Presence in the Eurodollar Market, 13 L. and Pol. in Int'l Bus. 997, 1003-1023, gives in full detail the history of support for and opposition to the Clearing House proposal from its submission to Fed through the Senate Hearings, Edge Corporation Branching; Foreign Bank Takeovers; and International Banking Facilities; Hearing Before the Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (July 16 and 20, 1979), to the final promulgation by the Federal Reserve Board of the Amendments to Regulations D and Q permitting the establishment of International Banking Facilities (IBF). It is these amendments, 46 Fed. Reg. 32, 426 et seq. (June 23, 1981), that are reprinted below.

The provisions are almost impossible to understand out of context because of being drafted as additions to and amendments of Regulations D and Q. The technicalities are explained somewhat in Lichtenstein, op. cit. and fully in the student note, op. cit.: the point is that if Euromarket funds (i.e. funds belonging to other banking institutions dealing in the Euromarkets, non U.S. entities other than banking institutions, or foreign affiliates of U.S. corporations that will use such funds for operations abroad) are booked at the IBFs and are only used (i.e. lent out or used to purchase liabilities of IBF eligible customers) for this particular set of customers, the funds are not counted for reserve requirement purposes. If, on the other hand, the U.S. bank borrows from its IBF, that is, uses the facility as a way of raising funds for the bank's participation in the domestic economy, then the IBF funds will be counted as part of the type of deposits against which the bank must hold 3% reserves. The aim of all the technical qualifications upon what may be in an IBF (e.g., the requirement that deposits from nonbanking institutions cannot be withdrawn before two business days after the date of deposit or date of notice of withdrawal) is to ensure that the assets and liablities so booked are not substitutes for more expensive domestic transactions. Apparently the rearranging of the monetary dike to permit Eurocurrency transactions enclaves within the United States has been successful; Washington Financial Reports, Vol. 39, No. 1 of July 15, 1982 at p.13 reports that the IBFs have booked $128 billion in loans and over $113 billion in deposits since December 3, 1981, the first date of opening of the facilities and quotes a Fed economist to the effect that there has not been a problem with "leakage."